

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Correa Analyst: John Pavalasky Bill Number: AB 382
Related Bills: See Legislative History Telephone: 845-4335 Amended Date: July 21, 2003
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Exemption/Interest On Bonds Issued By Federally Recognized Indian Tribal Government Located In This State

SUMMARY

This bill expands the list of bonds that are treated as California tax-exempt to include bonds issued by Indian tribal governments located in California.

SUMMARY OF AMENDMENTS

The July 21, 2003, amendments removed the prior contents of the bill and inserted a provision to allow an exemption from tax for interest income earned by non-corporate taxpayers on bonds issued by Indian tribal governments located in California.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to conform to the federal tax exemption for bonds issued by Indian tribal governments located in this state.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

All interest received or accrued is fully taxable except interest on tax-exempt state or municipal bonds.

However, if the use of the state or municipal bond proceeds is for private business use or is secured by property used for a private business use, that bond is treated as a "private activity bond" that must meet specific additional criteria in order to be treated as a tax-exempt bond. If the additional criteria are not met, the bond interest received is taxable. A detailed discussion of "private activity bonds" is contained in Attachment 1.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

John Davies for Gerald H. Goldberg 8/15/03

Indian Tribal Tax-Exempt Bonds

Starting in 1983, the Internal Revenue Code¹ was amended to treat Indian tribal governments as states for certain purposes, including the exemption from tax for interest on bonds issued by that government. However, tribal governments may issue tax-exempt bonds only if substantially all of the proceeds therefrom are used for an "essential governmental function." The regulations provide that the term "essential governmental function" shall not include "any function which is not customarily performed by State and local governments with general taxing powers" but includes projects for which federal assistance could be provided under the terms of legislation governing federal assistance to Indian tribes.

Indian tribal governments generally **cannot** issue tax-exempt private activity bonds. However, tribal governments can issue tax-exempt bonds to finance the acquisition, construction, reconstruction, or improvement of depreciable property that is part of a manufacturing facility provided that certain use, location, ownership, and employment requirements are satisfied. Thus, non-private activity bond obligations issued after December 31, 1982, by Indian tribal governments are treated as tax-exempt state bonds for federal income tax purposes unless they do not meet these criteria.

Indian Tribal Taxable Bonds

Indian tribal governments that issue taxable bonds do not have to comply with the requirements applicable to the issuance of tax-exempt bonds.

Current State Law

California law does not conform to federal law relating to exempting the interest earned on state or municipal bonds. In addition, the federal "private activity bond" rules have not been adopted by California. Also, the federal treatment of Indian tribal governments as states has never been adopted by this state.

California State and Municipal Bonds

The general rule in California is that for income tax purposes all interest received or accrued is fully taxable, except for interest on federal obligations (such as Treasury bills, notes, and bonds, as more fully described below) and tax-exempt bonds issued by this state or a local government in this state. Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California.

The California exemption from income taxation of interest on bonds of the state and its political subdivisions is contained in the California Constitution (Art. XIII, § 26. subd. (b).) The Revenue and Taxation Code further provides, by statute, that the federal "private activity bond" analysis shall not be made in determining whether interest on bonds issued by the state or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a state or local California issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax-exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

¹ Section 7871 of the Internal Revenue Code (26 U.S.C. section 7871).

California Conduit Revenue Bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond.

Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

Since the conduit revenue bonds issued in California are issued by this state or a local government in this state, the interest paid on such bonds is exempt from state income taxation under the California Constitution.

California Treatment of Federal Bond Interest

Interest earned on federal bonds is also tax-exempt for California income tax purposes. This results from federal law (31 U.S.C. § 3124(a)) that prohibits all states from imposing an income tax on interest income from direct obligations of the U. S. government. Examples of bonds that are exempt for California income tax purposes include those issued by federal land banks, the Federal Home Loan Bank, and Banks for Cooperatives. Not all federal bonds are direct obligations of the U.S. government and interest on those bonds is taxable. Examples of federal bonds not exempt are those issued by the Federal National Mortgage Association (Fannie Maes), Government National Mortgage Association (Ginnie Maes), and Federal Loan Home Mortgage Corporation (Freddie Macs).

THIS BILL

This bill would provide an exemption from tax for interest income earned by non-corporate taxpayers that own bonds issued by Indian tribal governments located in California.

This bill also expands the list of bonds that the statute specifically exempts from a “private activity” analysis to include those bonds issued by Indian tribal governments located in California. Thus, if the use of the proceeds from bonds issued by Indian tribal governments located in California are for private business use or are secured by property used for a private business use, the interest paid on that bond is, nevertheless, to be treated for California income tax purposes as tax-exempt.

OTHER STATES’ INFORMATION

See Attachment 1 for a discussion of the use of private activity bonds and a table showing the 2001 and 2002 volume caps for each of the states.

FISCAL IMPACT

This bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would not impact the collection of state income tax revenue. Under current law, federally recognized Indian tribal governments in this state can effectively get tax-exempt bond financing by way of tax-exempt “conduit revenue bonds.” So-called conduit bonds are issued by a public entity, such as the California Statewide Communities Development Authority, and the proceeds are lent to the tribe for public benefit projects. The statewide development authority created new policies in 2002 for gaming businesses and tribes looking for tax-exempt bond financing. Approximately 100 federally recognized Indian tribal governments currently exist in California.

ARGUMENTS/POLICY CONCERNS

This bill would expand the list of bonds that the statute specifically exempts from a “private activity” analysis to include those bonds issued by Indian tribal governments located in California. It could be argued that this bill would enable tax-exempt bonds to be issued directly by the Indian tribal government without requiring the participation of a state or local government in California. Thus, if the proceeds from bonds (or the security for the bonds) are used for private business purposes (i.e., building gaming facilities or purchasing land upon which gaming facilities are built), that bond is, nevertheless, to be treated for California income tax purposes under this bill as a tax-exempt bond. Some may question whether those bonds should receive a California tax-exemption in situations where it would not qualify as an exempt obligation for federal income tax purposes because of the private use restrictions under federal law.

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Attachment 1

Private Activity Bond Volume Cap In Millions

State Tax-Exempt Bonds

Tax-exempt financing is used by state and local governments to raise capital for public capital improvements and other projects provided that:

- no more than 10% of the proceeds are used by private parties, and
- no more than 10% of the debt service on the bonds is backed by private resources.

Private Activity Bond Rules

Certain types of projects that fail the 10% tests are nonetheless eligible for tax-exempt financing with private activity bonds because Congress has determined that these projects serve important policy goals. These exempt facilities include a variety of infrastructure projects such as public transportation facilities, solid waste and hazardous waste disposal facilities, and water and sewerage facilities. Various conditions and limitations apply to the use of tax-exempt bonds for each of these exempt facilities.

The federal tax code contains an additional group of programs for which private-activity bonds may be issued on a tax-exempt basis, provided the programs are qualified by meeting specific conditions and limitations. These include mortgage revenue bonds (MRBs), small-issue industrial development bonds (IDBs), and student loan bond programs.

In the Deficit Reduction Act of 1984, Congress imposed an annual statewide volume cap on the issuance of private activity bonds. In the Tax Reform Act of 1986, Congress established a unified volume cap that would include MRBs in addition to IDBs, student loan bonds, and other exempt facility bonds. A table is attached showing the 2001 and 2002 private activity volume caps (in millions) by state.

Federal tax provisions that provided for MRBs and IDBs, two of the most popular uses for private activity bonds, were originally slated to expire at the end of 1987. These provisions were extended several times since then and were made permanent in 1993.

In the late 1990s, a number of states began to exhaust their annual volume caps and were forced to postpone or cancel projects because tax-exempt financing could not be secured or to instead issue taxable bonds that are more expensive. If a state does not use the entire amount permitted under its annual volume cap, it can carry forward the difference for up to three years. Under current law, to qualify for the three-year carryforward, a state must designate a specific issuer and specific type of function to be financed. If a designated facility cannot be financed during the subsequent three years due to changes in market conditions, the state cannot reallocate the bond authority to another type of project elsewhere in the state.

The bond authority can only be used by the specific issuer and only for the approved use. As a result, states have virtually no flexibility in reallocating scarce tax-exempt bond authority under the volume cap to react to changing market conditions.

Attachment 1
Private Activity Bond Volume Cap In Millions

State	Population, 2000	Population, 2001	Vol. Cap, 2001	Vol. Cap, 2002	Percentage Change
Alabama	4,447,100	4,464,356	\$277.9	\$334.8	20.50%
Alaska	626,932	634,892	\$187.5	\$225.0	20%
Arizona	5,130,632	5,307,331	\$320.7	\$398.0	24.10%
Arkansas	2,673,400	2,692,090	\$187.5	\$225.0	20%
California	33,871,648	34,501,130	\$2,117.0	\$2,587.6	22.20%
Colorado	4,301,261	4,417,714	\$268.8	\$331.3	23.30%
Connecticut	3,405,565	3,425,074	\$212.8	\$256.9	20.70%
Delaware	783,600	796,165	\$187.5	\$225.0	20%
Florida	15,982,378	16,396,515	\$998.9	\$1,229.7	23.10%
Georgia	8,186,453	8,383,915	\$511.7	\$628.8	22.90%
Hawaii	1,211,537	1,224,398	\$187.5	\$225.0	20%
Idaho	1,293,953	1,321,006	\$187.5	\$225.0	20%
Illinois	12,419,293	12,482,301	\$776.2	\$936.2	20.60%
Indiana	6,080,485	6,114,745	\$380.0	\$458.6	20.70%
Iowa	2,926,324	2,923,179	\$187.5	\$225.0	20%
Kansas	2,688,418	2,694,641	\$187.5	\$225.0	20%
Kentucky	4,041,769	4,065,556	\$252.6	\$304.9	20.70%
Louisiana	4,468,976	4,465,430	\$279.3	\$334.9	19.90%
Maine	1,274,923	1,286,670	\$187.5	\$225.0	20%
Maryland	5,296,486	5,375,156	\$331.0	\$403.1	21.80%
Massachusetts	6,349,097	6,379,304	\$396.8	\$478.4	20.60%
Michigan	9,938,444	9,990,817	\$621.2	\$749.3	20.60%
Minnesota	4,919,479	4,972,294	\$307.5	\$372.9	21.30%
Mississippi	2,844,658	2,858,029	\$187.5	\$225.0	20%
Missouri	5,595,211	5,629,707	\$349.7	\$422.2	20.70%
Montana	902,195	904,433	\$187.5	\$225.0	20%
Nebraska	1,711,263	1,713,235	\$187.5	\$225.0	20%
Nevada	1,998,257	2,106,074	\$187.5	\$225.0	20%
New Hampshire	1,235,786	1,259,181	\$187.5	\$225.0	20%
New Jersey	8,414,350	8,484,431	\$525.9	\$636.3	21%
New Mexico	1,819,046	1,829,146	\$187.5	\$225.0	20%
New York	18,976,457	19,011,378	\$1,186.0	\$1,425.9	20.20%
North Carolina	8,049,313	8,186,268	\$503.1	\$614.0	22%
North Dakota	642,200	634,448	\$187.5	\$225.0	20%
Ohio	11,353,140	11,373,541	\$709.6	\$853.0	20.20%
Oklahoma	3,450,654	3,460,097	\$215.7	\$259.5	20.30%
Oregon	3,421,399	3,472,867	\$213.8	\$260.5	21.80%
Pennsylvania	12,281,054	12,287,150	\$767.6	\$921.5	20%
Rhode Island	1,048,319	1,058,920	\$187.5	\$225.0	20%
South Carolina	4,012,012	4,063,011	\$250.8	\$304.7	21.50%
South Dakota	754,844	756,600	\$187.5	\$225.0	20%
Tennessee	5,689,283	5,740,021	\$355.6	\$430.5	21.10%
Texas	20,851,820	21,325,018	\$1,303.2	\$1,599.4	22.70%
Utah	2,233,169	2,269,789	\$187.5	\$225.0	20%
Vermont	608,827	613,090	\$187.5	\$225.0	20%
Virginia	7,078,515	7,187,734	\$442.4	\$539.1	21.90%
Washington	5,894,121	5,987,973	\$368.4	\$449.1	21.90%

Attachment 1
Private Activity Bond Volume Cap In Millions

West Virginia	1,808,344	1,801,916	\$187.5	\$225.0	20%
Wisconsin	5,363,675	5,401,906	\$335.2	\$405.1	20.90%
Wyoming	493,782	494,423	\$187.5	\$225.0	20%
Dist. of Columbia	572,059	571,822	\$187.5	\$225.0	20%
Total	281,421,906	284,796,887	\$19,704.4	\$23,876.2	21.20%

Source: *The Bond Buyer*, December 28, 2001